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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET The "schizophrenic" technical condition of the market (referred to in Letter 233) continues. On October 16 the Industrial Average rallied to a new all-time high, but as seen on Chart #2, the response by the majority of stocks (i.e., the A-D ratio) has been very feeble. The fact that the A-D ratio has refused on four successive rallies to confirm new highs in the Industrial Average simply emphasizes the continuing (and dangerous) breadth-price divergence.

To add to the problem of "opposing forces", the Exchange last week announced that the total short position has increased to 6.8 million shares (from 6.2 million in September). This rise in the bear position in the face of the divergence (and along with steady odd-lot selling) is producing one of the most erratic and difficult markets this writer has seen since the summer of 1959.

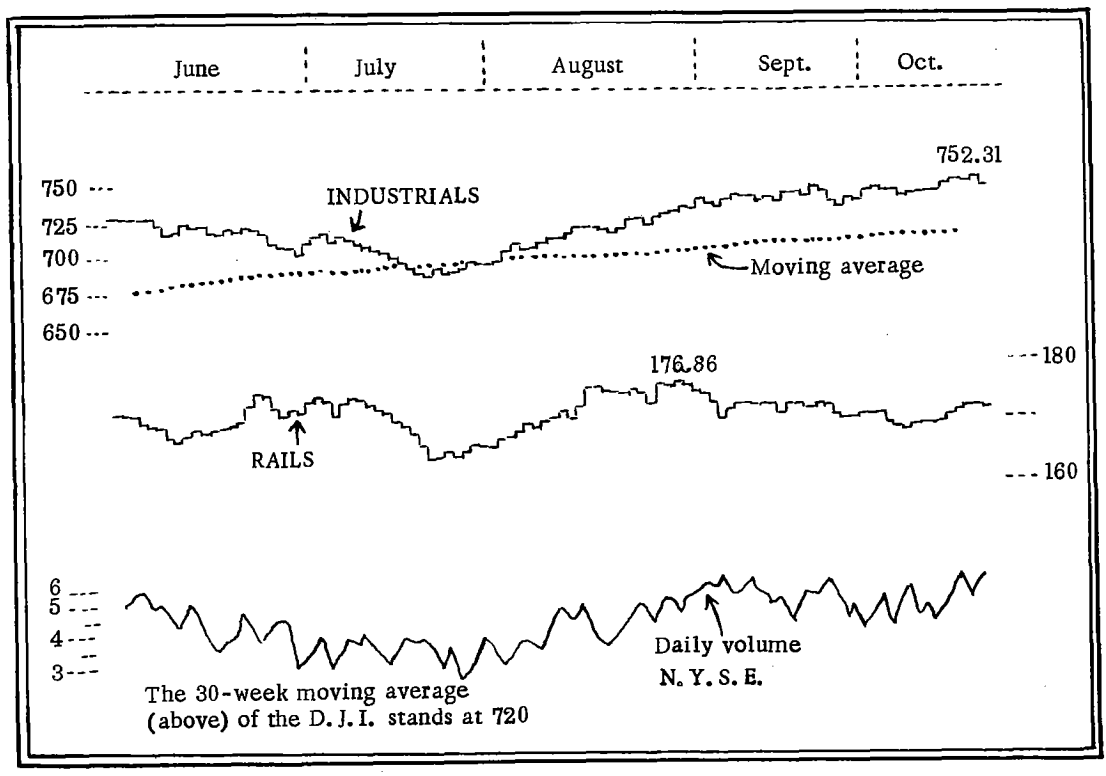
A GUESS Everyone seems optimistic about the longer term, but there is a good deal of near-term pessimism in evidence. Much of the pessimism has stemmed from the fact that (inexplicably) the current breadth-price divergence has become the most talked-about phenomenon on Wall Street. This wide recognition of technical trouble could have the effect of putting off the obvious. We could have a continued push by the Industrial Average -- with the majority of stocks refusing (as they have been) to join the parade. Then, when least expected, the serious trouble forecast by the divergence of the A-D ratio and the Rail Average could "take hold" (perhaps coincident with an important news event -- as happened during the January, 1960, steel strike settlement).

* * * * *

Letter #233 discussed probability and history, and I outlined in detail the action which has followed each breadth-price divergence since 1919. It was seen that in every case, these abnormal divergences marked an important downturn in the trend of the majority of stocks on the N.Y.S.E.

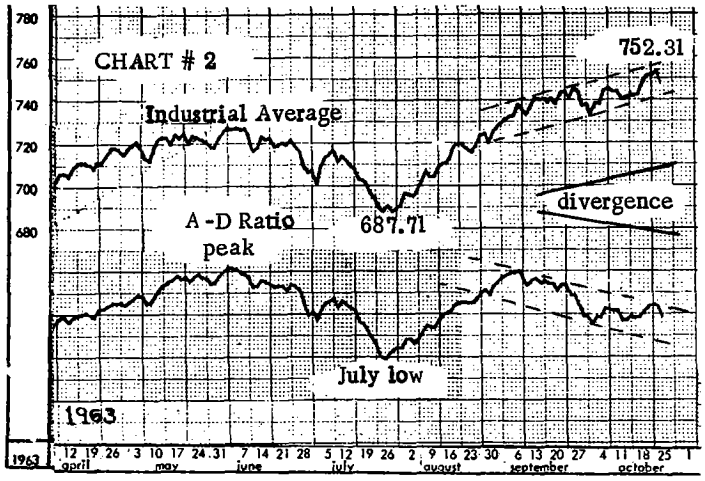
In the most recent instance, the A-D ratio recorded its 1963 recovery high on May 31. A general market reaction carried into June and July, following which a new rally began. The A-D ratio struck a second peak on September 5, but this peak failed to better the earlier May 31 peak. Industrials, however, continued to push higher with unusual results. Between September 5 and 23 a full divergence between price and breadth developed. Following the divergence, the A-D ratio (see chart #2) retreated half-way back to its July low -- but the Industrial Average refused to give ground.

Only once before (following a full price-breadth divergence) has the Industrial Average pushed to successive new highs. That was during the year 1959. I discussed the singular 1959 performance in Letters 232 and 233. Nevertheless, the action of the Industrial Average (i.e., new highs) since the September 23, 1963 divergence, again invites comparisons. As seen on chart #3, a full divergence between price and breadth occurred on May 26, 1959 (point A on chart). A rapid succession of Industrial rallies followed. Note that the 1959 action was "wild and wooly", and that each of the new Industrial peaks in turn gave way to a violent decline -- declines which took the A-D ratio to lower levels. Finally, in January, 1960, the Industrial Average got in gear with the persistently declining trend of

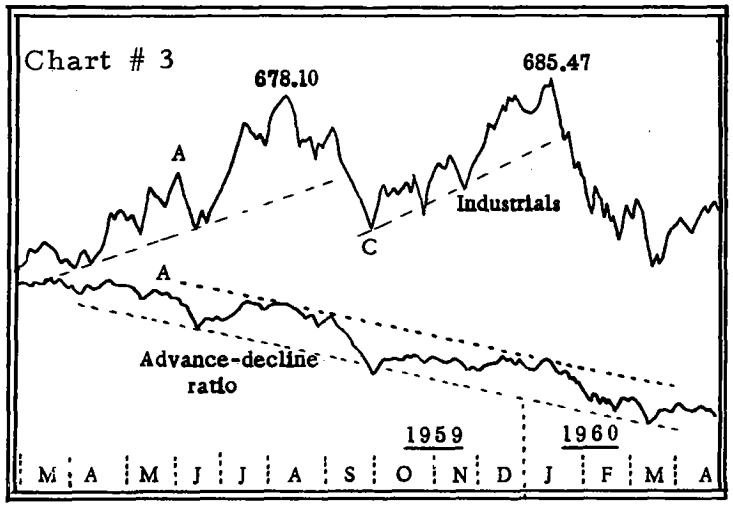


breadth, and a 119 point drop followed.

When the Industrial Average is pushing to new highs against a declining breadth trend, a technical vacuum is created. In the past such vacuums have always been "filled" by both indicators getting together on the downside. How long the current vacuum can continue is the big question. As explained in recent Letters, profits can be made in this type of market -- usually by buying the strongest stocks in the Industrial Average. But such profits are risky, and they must be "trading profits" of the type which were made during June-July and October-December, 1959 (study chart #3 carefully).



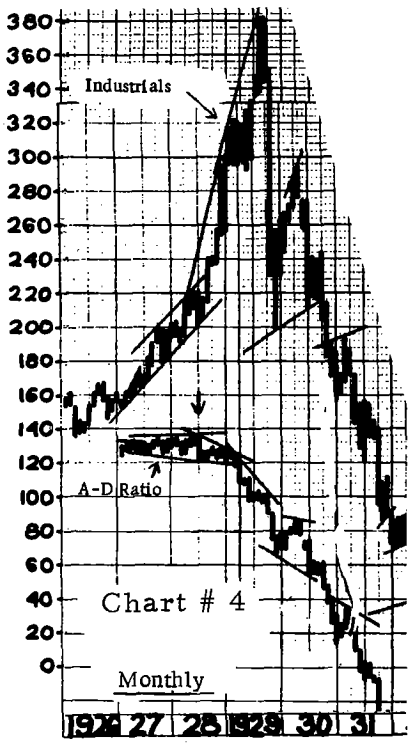
One further comment: the most extraordinary Industrial rise against a steadily declining trend of breadth occurred during late 1928 and 1929 (see monthly chart #4). Note that the A-D ratio "topped out" in July, 1928 (although this was not a divergence but simply a non-confirmation). Despite the steady collapse of the A-D ratio, the Industrial Average hurdled recklessly higher. Perhaps this extraordinary parting of the ways for price and breadth provided the technical undertone for the final reckoning in late 1929.



To predict that the current market will be a carbon copy of 1928-29 or 1959-60 is absurd. Nevertheless, we can only attempt to understand the present in terms of the past. And judging by the past, one fact looms as all-important -- breadth and price normally move together. When one speculates in a market in which Industrials are climbing against a major downtrend in the majority of stocks, he may make money -- but he is also "playing with fire."

BUYING & SELLING PRESSURE (Chart deleted this issue to save space). The Buying and Selling lines, as if reflecting the "split personality" of the market, have been zig-zagging back and forth -- with neither line moving very far. This would suggest that the undertone condition of the market is now about in equilibrium. This equilibrium has been in effect for 7 days -- during which time volume has been very high. The suggestion is that the majority of stocks are "churning".

MORE ON RELATIVE STRENGTH The first discussion of the use of relative strength (R. S.) techniques as an aid in stock selection appeared in Barron's in the issue of May 8, 1933. The article was written by Robert Rhea and was entitled "Stock Habits". In this article Rhea explained how he computed (during a given advance) the percentage of appreciation in the Industrial Average and the percentage of appreciation in a varied list of stocks. By comparing the percentage of change in each stock with the percentage of change in the Dow, Rhea was able to establish whether the stock was performing better or worse than the "market". Furthermore, Rhea concluded that if a stock performed consistently better or worse than a market over a few swings, that relative strength or weakness was very likely to continue.



If we divide the price of a stock by the price of any convenient Average, we will obtain a ratio figure. If the stock (over a period of time) outperforms the Average, the ratio figure will rise; the converse is true if the stock performs worse than the Average. These two statistics (i.e., the price of the stock and the ratio figure) are then plotted on semi-logarithmic graph paper. One line of the graph will show the stock's actual movements in terms of percentages (since "log" paper deals in percentages), and the other line will show whether the stock is performing better or worse than the Average (and this too will be shown in percentages). This second line is the R. S. line, and conclusions drawn from the trend of R. S. can be extremely important in the selection of stocks.

I have noted that since 1959 each broad market movement seems to have been increasingly difficult from the technical standpoint. Stocks that "acted" beautifully during the 1953-56 and 1958-59 rises began (after 1959) to behave erratically, as far as technical analysis was concerned. I have little doubt that part of the difficulty stemmed from the astounding rise of technical analysis and charting throughout the nation. It seemed as if "too many cooks were spoiling the broth", and the more converts to charting, the

more misleading the charts seemed to become. Finally, the 1961 "top" materialized into a classic of "false breakouts", erratic starts, and costly rises and reversals. After the 1962 collapse, the market started up with many stocks having failed to form any recognizable base of accumulation or, for that matter, any orthodox pattern at all. One simply had to buy them with the hope that they would continue to rise.

During the period since 1959 and particularly since 1961, I tested every conceivable method in a continuing search for a tool which might aid in stock selection. Technical analysis of individual stock charts was proving inadequate.

From my own experience, I believed that relative strength studies might be the answer. I knew that relative strength (R. S.) trends were persistent, often lasting as long or considerably longer than a given movement in the general market. Furthermore, if the market was rising or simply moving sideways, and a stock was showing improving R. S., then obviously that stock was on its way up. It did not matter whether the stock was breaking out of a triangle or any other pattern, since improving R. S. in a static or rising market means appreciation.

From this, the following progression seemed logical: (1) Start with those stock groups which show the best R. S. -- preferably groups which are in the act of definitely turning up after long R. S. declines. (2) Pick the stocks with the best R. S. within the strong R. S. groups. (3) Then pick the stocks with the best actual technical patterns from the strong R. S. stocks. These final choices can be expected to outperform during any market movement. But when they stop outperforming, when their R. S. line reverses or when the general market registers a "sell signal" -- they should be sold.

The small weekly charts showing price action and R. S. since 1960 are worth analyzing in terms of the usefulness of R. S. in technical analysis. Avco reached the 29 area twice. The second (most recent) thrust could have been accepted as the beginning of an important new rise past the old high. But when Avco's R. S. line broke down, the implication was that the stock had formed a "double top" and was a sale.

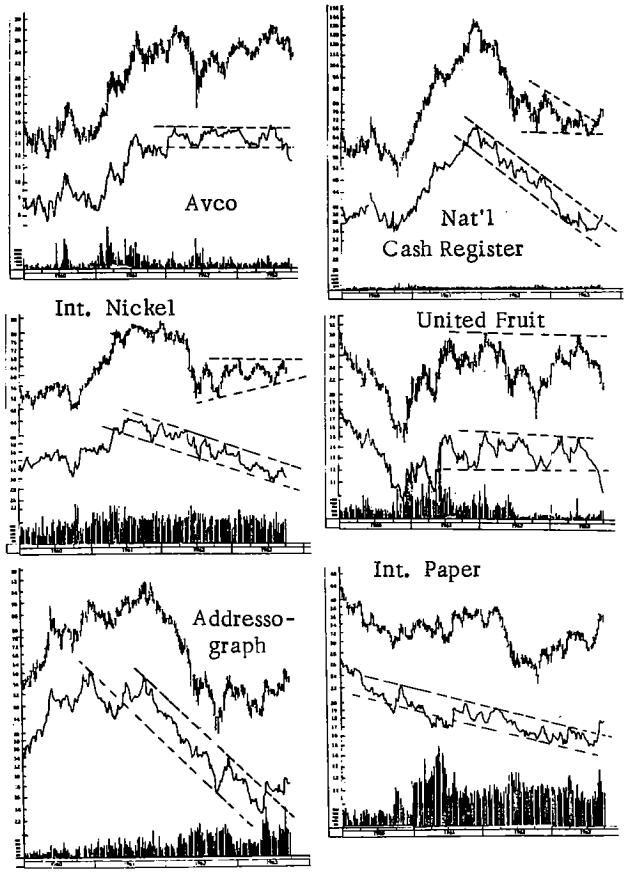
National Cash formed what appeared to be a huge (bearish) descending triangle. As such, NCR seemed to be a perfect short. But when its R. S. line broke out of the long descending channel, NCR appeared stronger than weak. As such, shorts in NCR should be covered.

The very opposite occurred in Int. Nickel. A large (bullish) ascending triangle formed, but note that despite this, Nickel's R. S. had been steadily dropping. The triangle should not be trusted -- or certainly not until R. S. confirms on the upside.

United Fruit, like Avco, seemed ready for a massive move through the old highs. It was highly touted on Wall Street, and the move from the 1962 lows was sensational. But its R. S. line showed a little less strength at each peak. When the R. S. line broke sharply, it was the signal that "it was all over" with United Fruit.

Addresso-Multigraph seems to have formed an excellent base. We see its R. S. line confirming the upward price action, and thus AIN should be a buy in any kind of decent market.

Int. Paper, after lagging in popularity for years finally reversed its R. S. a few months ago. IP is outperforming the market and is one of the stronger stocks in the Average. Note that IP has not risen out of any recognizable base formation -- but the stock is nevertheless bullish.

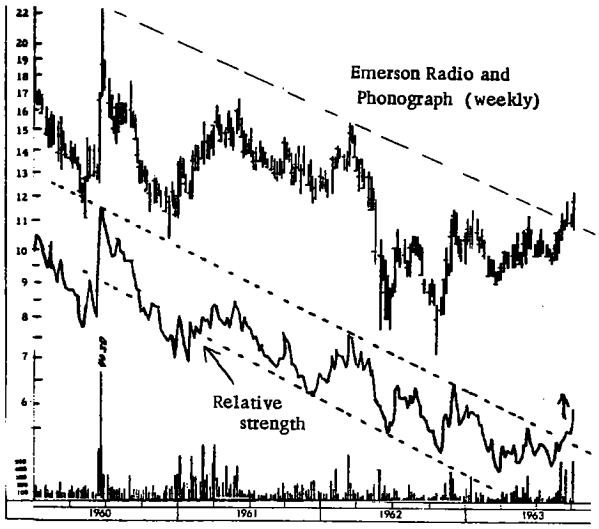


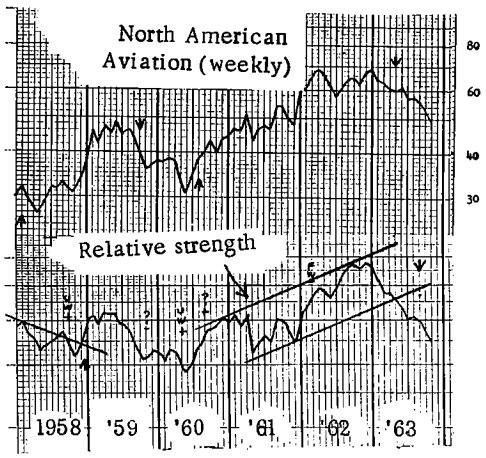
STOCKS Of 432 stocks tabulated here each week, 302 (or 70%) are now holding above their 200-day moving average, no change from last week (tabulations are from Quote Digest, 110 North Lorraine, Wichita, Kansas).

With this Letter I am starting a new feature which will consist of continuous stock selection and supervision based (largely) on R. S. studies. I feel that this may be the best way for subscribers to "test" the usefulness of R. S., and it may also be both instructive and profitable.

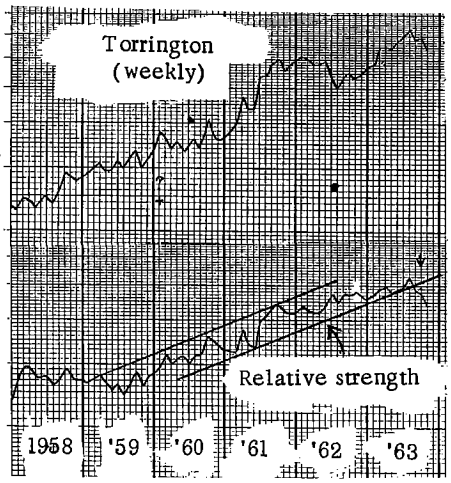
In Letter 232 I recommended the sale of utility stocks. This group has been behaving poorly, and the group R. S. line has turned decisively down. Whether the "New Frontier" is planning to interfere with the utility industry or whether the trend of money rates is exercising an adverse force I do not know. But below we see Florida Power & Light. Its R. S. is in a downwa rd channel, and I will put this down as a short sale (price about 72).

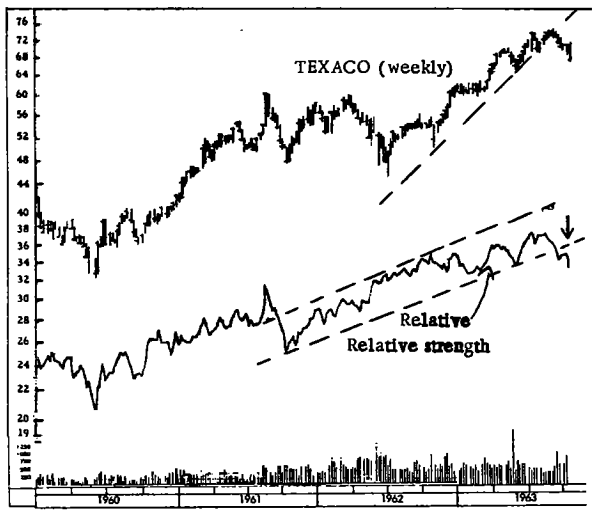
In Letter 226 I recommended shorting North American Aviation at around 58. It has since dropped to 48. On top of this, Wall Street is saying that the Aircraft Industry has now discounted the worst as far as a "pullback" of military expenditures is concerned. But as seen on the chart below, North American's R. S. line is still pointing down, so we will be stubborn and short it here (price about 48 1/2).





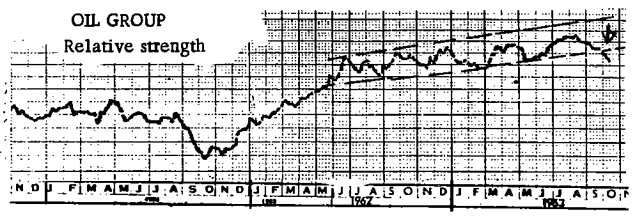
The chart of the Oil group shows a penetration of a one year rising R. S. channel. The Oils are now acting weaker than the market on a trend basis. Texaco, one of the major Oils, may be considered a short on the basis of its own reversal of R. S. TX's price action would seem to confirm its R. S. action.



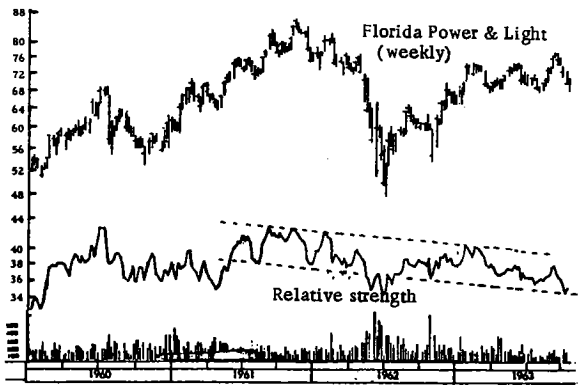


Torrington Co. has broken a five-year uptrend in R. S. It was recommended as a short in Letter #232. We will short it here at a price of about 65.

On the long side we will buy Emerson Radio (ERP) on the basis of the upside penetration of the very long descending channel in both price and R. S. We will buy Goodyear (in the Industrial Average) on the basis of outstanding strength (see Letter 232). We will also buy Jones & Laughlin (Letter 230) on the basis of the reversal to the upside in Steel R. S. and the outstanding characteristics of this stock in particular. Last, Addresso-Multigraph (chart on page 3) will be put down as a buy for the reasons described on page 3.



Date	Stock Bought	Stock Shorted	Name
Oct. 23		72	Florida Power & Lt.
Oct. 23		48 1/2	North American Av.
Oct. 23		65	Torrington Company
Oct. 23		68	Texaco
Oct. 23	12 1/4		Emerson Radio
Oct. 23	67		Addresso-Multi.
Oct. 23	42 1/2		Goodyear
Oct. 23	63		Jones & Laughlin



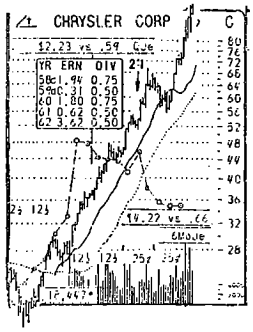


Chart of the Week Here we see the weekly chart of Chrysler. Note that C's 200-day moving average is now about 62. The stock is in a "stilt" (straight-up") formation, and is overdue for a correction. A correction is in order when a stock pulls more than 20% above its 200-day moving average. One further comment: my guess is that the collapse of the entire Industrial Average will occur simultaneously with the ultimate collapse of the stilt formation in Chrysler.

Charts on page 3 and TX, ERP and FPL (page 4) courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003. Charts of Torrington and North American courtesy of Ray * Signals, 141 Broadway, N. Y. C. 6. Chart of Chrysler courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas.